WITH ALL GOOD INTENTIONS

THE COLLAPSE OF JAMAICA'S DOMESTIC FINANCIAL SECTOR

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Introduction

Jamaica's financial sector—which was primarily domestically-owned and -controlled—grew substantially in the 1980s before collapsing in the mid-1990s. An Inter-American Development Bank (IADB) Data Base Report indicates that between 1986 and 1990, Jamaica's financial sector rose 19 percent in real terms, from US$248 million to US$295 million, compared with a 7.2 percent increase for Latin America's financial sector. Between 1990 and 1995, however, the sector declined from US$295 million to US$170 million, a 42.4 percent drop (after devaluation), contrasted to a growth of 17.2 percent in Latin America (see Appendix I for IADB Statistical Profile on Jamaica).

In nominal terms, the sector grew substantially with the number of commercial banks, building societies, and financial institutions expanding from 36 to 57 between 1980 and 1997, and total assets increasing from J$2.5 billion to J$192.6 billion (US$1.4 billion to US$5.205 billion).

Commercial banks and merchant banks experienced the highest growth within the sector. Between March 1980 and March 1998, the assets of commercial banks rose from J$1.920 billion to J$157.235 billion, while deposits grew from J$1.338 billion to J$109.437 billion. In 1980 there were only a few merchant banks—and those were largely inactive—but by June 1997 the number stood at 27: their assets rose from J$129.7 million to J$ 17.934 billion over the same period.

As a result of the collapse of the financial sector, the government intervened in early 1997 by announcing a blanket guarantee for all deposits, pension funds, insurance policies, and investment instruments in institutions falling under the Banking, Financial Institution, and Insurance Acts.

Institutionally, the government established the Financial Sector Adjustment Company (FINSAC) in late 1996. Since its establishment, it has become the largest holding company in Jamaica, owning some 158 companies and holding investments in nearly all of the domestically-owned financial institutions. By mid-1998, it had provided support by way of acquisitions and soft lending totaling J$73.5 billion (US$1.9 billion). Of this sum, J$68 billion represents support to the banking sector covering 1.5 million depositors. FINSAC now owns or controls all of the domestic banks (except for the tiny Trafalgar Bank), or approximately 60 percent of the banking assets, and approximately 90 percent of the life insurance industry.

FINSAC's intervention on such a major scale has changed Jamaica's fiscal landscape. Its support of J$73.5 billion equals nearly 60 percent of the current year's budget of J$130 billion. With debt servicing on the order of at least J$15 billion, this will increase the government's annual burden by another 12 percent, bringing it to a total of about 65 percent, and still increasing, with current estimates close to about 80 percent.

Growth in Merchant Banking

The rapid growth in the banking sector was due primarily to the rise of merchant banking in the 1990s. Ease of entry under the law applicable to such entities (Protection of Depositors Act) allowed for minimal capitalization and provided for few restrictions on the scope of operations in terms of loans and investments. The major restriction limited the level of deposits to 20 times capital, and even then, the definition of capital was loose enough to include the capitalization of non-revenue reserves.

The surge in merchant banking in the 1980s was different from the earlier experience in the 1960s when, in the post-independence euphoria and during a strong economy, there was an influx of foreign-owned merchant banks, for example, Bank of America, Chase, First Chicago, and Crown Continental. These entities were geared more toward public sector financing and did, in fact, mobilize overseas funds to do so.

For example, in March 1980 foreign liabilities of merchant banks were J$55.6 million, while deposits were J$30.3 million. By June 1984, however, when all of the major overseas merchant banks had ceased operations in Jamaica, foreign liabilities had fallen to J$17.3 million, while domestic deposits had grown to J$117.2 million; the newly established Eagle Merchant Bank, the forerunner of the new surge in merchant banks, accounted for J$93.9 million, or 80 percent of total deposits.

In addition to the advantages cited, the liquid reserve requirement was lower for merchant banks than it was for commercial banks. For example, the liquid asset reserve requirement for commercial banks was as high as 48 percent in April 1985, and increased to 50 percent in July 1992, of which 25 percent (or one-half) had to be in a non-interest-bearing account with the Central Bank. In the case of merchant banks, the liquid asset reserve requirement reached a high of 25 percent in December 1985, and peaked in May 1996 at 35 percent, inclusive of a 17 percent non-interest-bearing cash reserve.

The differential in reserve levels was a contentious issue, with the commercial banks arguing that it amounted to an unfair advantage for the merchant banks. The merchant banks rebutted that the commercial banks had the advantage of being able to attract interest-free current account deposits and low-interest-bearing savings accounts.

Using the advantages cited above, the merchant banks displayed dynamism and innovativeness by introducing new products and developing new approaches to banking. For example:

1. Merchant banks pioneered lease financing, which had certain tax advantages because write-offs were permitted on lease payments. This avenue of financing allowed companies to raise capital to acquire new assets as well as to re-finance existing assets whose values had been fully depreciated. Accordingly, a company did not have to tie up all of its cash to acquire additional assets and could, in fact, achieve higher gearing from its existing resources.

This initiative led to widespread use of lease financing, with strong competition from the life insurance industry and pension funds, to the point where merchant banks eventually lost their competitive edge.

2. Consortium financing was developed and used extensively for new hotel developments. This was pioneered by Eagle Merchant Bank which, in 1985, brought together 15 financial entities to finance the 236-room Sandals Ocho Rios Hotel project. This was the forerunner of many more consortium-funded hotel projects, and it was the first time that the financial sector—banking and insurance—collaborated on a structured basis to finance the tourism sector without reliance on government guarantees.

3. The government's privatization program was also strongly supported by merchant banks. The merchant banks were involved in the privatization of the Jamaica Telephone Company, Radio Jamaica, Caribbean Cement Company, and the National Commercial Bank. Again, Eagle Merchant Bank played an important lead role, working in conjunction with its associated stock brokerage company, Paul Chen-Young and Company. It advised on divestment strategy, performed an underwriting role, and acted in a lead broker capacity.

   In the case of the divestment of the National Commercial Bank, Eagle's banking arm played a vital role in providing finance to allow thousands of Jamaicans to acquire shares in the company. In the divestment of the sugar industry, it was a merchant bank (Manufacturers Merchant Bank) that put together a consortium and served as the lead investor.

4. Merchant banks took a special interest in providing advice on company re-structurings, take-overs, and acquisitions. In performing such functions, along with other related services, investment banking became the buzzword in the financial arena.

5. Merchant banks mobilized overseas resources. Funds were sourced for project lending, in contrast to the working capital financing provided by the commercial banks. Again, Eagle Merchant Bank played a leading role by raising over US$80 million from international financial institutions for project financing, including for the government of Jamaica.

6. New approaches were employed to aggressively attract domestic savings by measures such as paying interest on deposits on a monthly basis, which has proved extremely beneficial to pensioners. The merchant banks provided life-insurance-linked savings schemes and created worker saving plans to complement pensions.

7. The Eagle Merchant Bank expanded overseas, opening a branch in the Cayman Islands, establishing a representative office in the United States, and acquiring a stockbrokering firm in the United States. This strategic move was taken in order to tap into the global financial market and to provide a vehicle for Jamaicans living overseas to invest in their home country.

8. Merchant banks competed with the commercial banks by being aggressive and flexible. For instance, the merchant banks provided for more structured loan financing on a term basis, rather than the traditional type of overdraft financing offered by commercial banks.

While merchant banks played a leading role in bringing change to the financial sector, their operations cannot be divorced from those of commercial banks and life insurance companies. Indeed, most of the major merchant banks were subsidiaries of commercial banks, and their operations were dovetailed with their parents. Where practical, term deposits were channeled to the merchant banks, especially to take advantage of lower liquid reserve requirements, and loans were sometimes structured to allow the merchant bank to make term loans while the commercial banks dealt with current accounts and the operating needs of the client. The sharing of securities was also easily facilitated where there was loan participation.

Banking Reform

Banking reform was inevitable because the laws needed to be upgraded to keep up with international banking practices. Changes were, therefore, incorporated in the amended Banking Act and the enactment of the Financial Institutions Act (FIA), which replaced the Protection of Depositors Act at the end of 1992. Prior to the amendments, extensive consultations took place between the banking sector, the Ministry of Finance, and the Bank of Jamaica. All sides recognized that difficulties would result from the substantive changes and that the sector's ability to cope and continue to foster and support the development of the Jamaican economy had to be considered.

Some of the many substantive issues that were addressed in the consultations are discussed below.

Dealing with Hard Core Overdrafts

Traditional banking in Jamaica consisted of funding heavily indebted, under-capitalized companies that "borrowed" by way of overdrafts. This type of bank financing came to be regarded as a form of almost permanent capital, and one of the proposed changes was intended to encourage more regular debt servicing. One way this problem was addressed was to convert overdrafts to term loans with fixed repayment obligations. This meant that the companies would be required to make regular debt serving payments. While this was highly desirable, it placed serious pressures on the cash flow of companies. The fundamental shift was to move away from asset-based financing to one geared toward cash flow.

Treatment of Interest on Non-performing Loans

Prior to the amendments, some financial institutions were accruing interest on loans on which no payment had been made for at least six months. With the amendments, banks were required to reverse their interest accruals from income once payments on a loan were three months in arrears. The impact of this change had an adverse affect on the profitability of banks, as illustrated by the fact that the largest domestically-owned bank (National Commercial Bank) was forced to classify J$13.5 billion of its loans as non-performing. This amounted to nearly four times the bank's capital base of J$3.8 billion, and FINSAC came to the rescue by purchasing these loans as well as a J$7 billion loan due from the bank's parent, Mutual Life Insurance Company.

Limitation on Lending to Connected Parties

The limitation on lending to related entities was a major change for the banking industry. The definition of a connected party, as stated in Section 4(2) of the Banking Act, was extremely broad:

> For the purposes of this Act, the following persons shall be treated as being connected with a given bank ("B") and the bank with them, and shall be so treated notwithstanding that at the relevant time any of the persons in question (not being individuals) had not yet come into existence or had ceased to exist –
>
> (a) holding company or subsidiary of B
> (b) subsidiary of a holding company of B
> (c) holding company of a subsidiary of B
> (d) any company of which B has control
> (e) any company of which B and persons connected with B together have control
> (f) any company which together with B constitute a group
> (g) an individual who is a director, manger, or person who has control of B or any partner or any immediate relative of such director, manager, or person as aforesaid
> (h) any company of which any of the persons referred to in paragraph (g) is a director, manager or has control

Recently, the governor of the Central Bank, Mr. Derrick Lattibeaudiere, has expressed public concern about the definition, and has implied that it will be amended. As at March 1998, the 20 percent lending limitation to related parties, based on capital, was exceeded by the country's two largest banks (25.1 percent for National Commercial Bank and 24.8 percent for Bank of Nova Scotia).

Two of the concerns in dealing with the issue of related parties are:

(a) directors who sit on a bank board would be treated as a related party when that bank does business with an entity on whose board that director sits, and

(b) entities in a conglomerate cannot have combined secured borrowings in excess of 40 percent of a bank's capital base, and a maximum of 20 percent to any individual or company within a group.

In a small economy, there is a shortage of experienced and knowledgeable persons who would be suitable directors for either banks or other companies. Further, banks need good companies as their clients, just as companies need sound banks to meet their financial needs. The conglomerate restriction is therefore a strain on both banks and companies, in that it limits either the number of boards that an individual can sit on, or it limits the amount of business that companies and banks can conduct together.

Definition of the Banking Sector's Role in Development

The issue of the proper role of the banking sector in Jamaica's development was probably the most important in terms of policy. One school of thought was that the banking sector had the primary responsibility and greatest resources to invest in Jamaica (while undertaking risk management). Supporters of this theory argued that the banking sector's more direct involvement in the productive sector was vital for investment and growth. The German, Japanese, and French banking models were cited to support this point of view.

The other model confined the banking sector to the traditional banking tasks of providing short-term working capital financing, staying clear of any long-term position. The UK, Canadian, and U.S. approach to banking supported this model.

The discussions over which of the two models was best suited for Jamaica were eventually finalized under the chairmanship of the late G. Arthur Brown, then governor of the Bank of Jamaica. On the fundamental issue of how involved the banking sector should be in making direct investments in enterprises, limits of 20 percent of capital in any one entity other than financial institutions and 40 percent of capital for all investments were set.

The exemption of investment limits in financial institutions recognized that in many cases, such investments had already been made. Also, the collateral benefits of such investments could be substantial (e.g. deposits), and the risk of investing in a related field (about which the banks would presumably be more knowledgeable) should be lower than the risk associated with lending in other sectors of the economy.

Regulations

Other provisions were more of a regulatory nature:

(a) stronger provisions regarding licensing, minimum levels of capital, and levels of deposits
(b) stricter prudential controls on the activities of institutions, such as insider loans
(c) greater scrutiny of persons acquiring control of institutions
(d) strengthening of the powers of the supervisors, both the Inspection Department and the minister of finance
(e) enhancement of the Ministry's and the Bank of Jamaica's regulation-making powers to achieve greater flexibility in areas such as adequacy of capital, solvency, cooperation from auditors, and maintenance of

high personal standards among persons working in the banking industry

(f) a full and comprehensive mechanism for identifying and dealing with offences relating to institutions, including ways of rescuing troubled institutions

Decline of the Sector

Following the banking amendments in December 1992, a new governor, Jacques Bussieres, who had an unenviable record in Zambia, assumed office in 1993. The demise of the domestic financial sector began during his term of office as he sought to change the strategic role of financial conglomerates as envisaged by the Arthur Brown model and engaged in inappropriate monetary policies.

Mr. Bussieres made no secret of his opposition to financial conglomerates, criticizing them on radio talk shows and in public speeches. His philosophy was that the most appropriate model for Jamaica was to ensure separate ownership of financial entities such as insurance companies and banks, creating what he termed a “Chinese wall” between them. By taking such a position publicly, he unwittingly helped to undermine the domestic financial sector which had begun to suffer from a creeping lack of confidence. This antagonism to financial conglomerates was a reversal of international banking trends, especially in the United States, where the Glass-Steagall Act was soon to be repealed, and in Canada, where banks were acquiring stock brokerage firms and distributing insurance products. The official position of the government has supported the Chinese wall model by insisting on separate ownership of insurance companies and banks.

The collapse of the domestic financial sector was triggered by the closure of Century National Bank in early July 1996. That banking group, along with nearly all the indigenous financial institutions, was more involved in direct investments than were its overseas-owned counterparts (Citibank, Bank of Nova Scotia, Canadian Imperial Bank of Commerce). These foreign-owned banks stuck to the traditional conservative lending path and had a significantly higher percentage of their deposits in government paper.

There are many reasons, some inter-related, for the failure of the financial sector. The problem faced by the banks was essentially that of bad debts, while for life insurance companies the difficulties were caused by investments in equities, real estate, and hotels. The industry’s over-exposure in investments financed by high-cost, short-term funds played a role in the crisis, as did the declining economy and the sustained high interest rates (in excess of 40 percent for five-plus consecutive years). The actions of directors and management, the failure of the industry to take a coordinated approach, and the weak regulatory environment also were contributing factors.

Investments

The life insurance companies relied heavily on expensive short-term commercial paper to make long-term investments, a practice that legitimately has received criticism. The fact is, however, that the life insurance companies aggressively raised short-term funds at a time of high inflation, when it was difficult to market long-term insurance savings plans (e.g. endowment policies). The life insurance companies, acting independently, entered this market in order to compete with the banking sector and the government for local savings—a decision that proved extremely costly to their operations.

Investments made by the financial sector, especially by life insurance companies, were particularly important to the tourism sector. While some of these investments might not have been justified on financial grounds, there could be an economic justification for creating productive capacity and ameliorating social discord (creating jobs and therefore tax revenue for the government; enhancing foreign exchange capabilities, the benefits of which accrue to the country).

In assessing the financial sector's investments, a distinction must be made between investments in financial entities and those in commercial entities. In the case of the former, there was no restriction in the law on the size of an investment on the basis that there could be complementarities and economies of scale. Eagle Merchant Bank investments in Eagle Commercial Bank, Eagle Unit Trust, Eagle Permanent Building Society, and Eagle General Insurance Company demonstrated that the model could work. These entities were profitable, and Eagle Commercial Bank was in fact the most profitable—based on return on assets and revenue per employee—of the domestic banks. But the investments by Crown Eagle Life Insurance Company in the real estate sector proved to be untimely and were the main cause of the eventual collapse of the Eagle financial network.

While the model supporting direct investments by the financial sector in other financial entities has shown some success, the experience with the financial conglomerates has demonstrated that there could be such intertwining of activities as to create contamination. This is exemplified by the collapse of the Century Group, the Crown Eagle Life Insurance Company (the ultimate owner of Eagle Commercial Bank), Mutual Life Assurance Company (which owned a controlling interest in National Commercial Bank), and Life of Jamaica (which owned a controlling interest in Citizens Bank). In these cases, the operations of the commercial banks were jeopardized because they had over-extended loans to their parent companies in order to fund massive runs in mid-1996 and early 1997, and, in the case of Victoria Mutual Building Society, because it had funded its commercial bank subsidiary, Island Victoria Bank.

The core problem was caused by investments made in the real estate sector, especially tourism (where a cardinal mistake was made by mismatching investment funds in a high-interest-rate environment). In the stock market, the index fell by approximately 50 percent and there is now no liquidity to dispose of any sizeable blocks of shares.

Economic Climate

There is a strong case to be made that the economic climate that prevailed in the 1990s contributed to the downfall of the sector. Inappropriate and inconsistent monetary policy created hardships, resulting in the inability of borrowers to repay loans, inadequate returns on investments to cover funding costs, and falling values in investment portfolio and property values. Money supply fluctuated sharply, inflation and bank lending rates were high, and exchange rates plummeted, as shown below:

Year	% Change in Money Supply	Inflation Rate	Comm. Bank Lending Rate	Exchange Rate J$:US$
1991	63.5	80.2	40.1	12.85
1992	76.7	40.2	46.4	23.01
1993	43.7	30.1	61.3	25.68
1994	24.3	26.9	56.1	33.35
1995	25.2	25.5	55.2	35.54
1996	18.8	15.8	55.2	37.02
1997	14.0	9.2	44.2	35.58

Fluctuations in monetary policy and the resulting inflation, along with a 0.3 percent average annual growth rate in gross domestic product (GDP) between 1990 and 1997, created an unfavorable operating environment for businesses and made it difficult for them to service their debts. Ultimately, the problems spilled over into the financial sector.

Management Decisions

While the harsh economic climate adversely affected the direct investments made by the domestic financial entities, blame must also be placed on the directors and managers of the failed entities based on their poor management decisions, outright mismanagement, and, in certain cases, alleged financial irregularities.

How could so many directors sitting on the boards of various financial entities have made so many “bad” and untimely investments? It is necessary to note the mood of the 1980s and the early 1990s, when there was official government policy support for the expansion of the domestic financial sector into the productive sector, e.g. tourism and agriculture, in the absence of significant foreign investment in those areas. In the case of agriculture, the most notable examples were National Commercial Bank’s investment in citrus, papayas, and mangoes, and the Manufacturers Merchant Bank’s investments in sugar.

Those at the helms of the domestic financial entities were nationalistic in their outlook, and many genuinely felt that they had a responsibility to be at the forefront in helping the country to develop. Many of the assets (primarily in the tourism and sugar industries) that were acquired by the financial sector had been divested by the government, which encouraged the indigenous financial sector to participate in the acquisition process.

Directors and management were operating in an environment of recurring currency devaluations (the exchange rate was J$1.80 to US$1 in 1980; J$5.56 in 1985; J$17.18 in 1990; and J$37.02 in 1996). Many entities felt that their survival depended on their ability to protect their capital base by investing in foreign-exchange-earning assets. These substantive factors must be borne in mind when attempting to evaluate the systemic errors of judgement on the part of those responsible for the affairs of the troubled domestic financial sector.

The Role of FINSAC in Determining Which Entities Fail

The definition of a failed or insolvent financial institution is an important issue because, in fact, FINSAC's decision on how to act actually determined which entities "failed." For example, FINSAC purchased the bad debts and investments of National Commercial Bank, Life of Jamaica, Mutual Life, Island Life, and Dyoll Life, and provided soft loans and preference shares to keep these entities afloat. All these institutions would have folded had it not been for FINSAC's assistance.

In contrast, FINSAC assumed full ownership and control of the Century National Bank Group, the Eagle Financial Group, Workers Bank Group, Horizon Merchant Bank Group, Caldon Finance Group, and some others. Some have since been closed, while others are still operating—even with a negative capital base.

Only FINSAC has the information necessary to justify its discretionary treatment of the various troubled financial entities. What seems clear, however, is that it has neither articulated nor demonstrated any coherent policy for tackling the problem of the financial sector. By supporting and taking over entities without any budgetary authorization and funding, it has created a major fiscal problem. The need for appropriate measures to regularize this situation will have to be addressed.

There is no doubt that FINSAC's intervention in the financial sector was vital, if late, and that it helped to restore confidence and stability. But FINSAC's intervention was not based on any structured operational plan. For example, the bailing out of financial institutions that were clearly insolvent protected the interests of the shareholders, directors, and management of those favored entities. That was not the case for the management and shareholders of institutions that were not so favored. Hiving off or acquiring bad or doubtful debts and investments and providing subordinated loans and quasi-equity were the methods used to "save" some of the favored entities. It could be argued that any of Jamaica's troubled financial institutions could have been saved with such support.

An entity is either solvent or insolvent, and the size of the insolvency should not be used to justify which entities deserve to be saved. What *is* important is the future viability of any re-structured entity, and management's capacity to bring about success.

Another example of FINSAC's inconsistency relates to the disposing of the entities and assets it has acquired. The recent decision to create a holding company to consolidate four commercial banks and a merchant bank could delay divestment. Only one of those entities is viable and, instead of selling the profitable entity, FINSAC will create a paper company that will have negative equity unless a substantial capital injection is made. The result will be that FINSAC's debt will be increased in order to support this holding company. This would not be the case if a more businesslike and efficient divestment policy were pursued.

FINSAC's Treatment of Directors

The treatment of directors is another important issue that arises from FINSAC's interventions. Are the directors and management of the "favored" financial entities "fit and proper" while those of the not favored are "un-fit and un-proper"? Clearly, it is unfair to judge directors and managers based on the "success" or "failure" of an institution if such success or failure depended on FINSAC rather than on the competency of the directors and managers. In other words, the success or failure of an entity depended less on the directors and managers and more on FINSAC's decision on whether or not to prop up the institution by purchasing non-performing loans and injecting capital through the making of subordinated loans. The treatment of directors of failed institutions should be the same as for the directors of entities which would have failed without support from FINSAC.

In some cases, a financial group had both profitable and unprofitable entities. On the principle that it is ultimately the directors who must take the responsibility for the affairs of an enterprise, how should directors who sit on boards of companies within such a financial group be treated? It would be highly discriminatory to arbitrarily treat some of those directors as "fit and proper" while others are not dealt with in a similar manner.

Regulatory Environment

The regulators (the Bank of Jamaica and the superintendent of insurance) failed to recognize the growing difficulties in the financial sector and were late in acting to minimize and resolve the problem. The capability of the regulators did not keep pace with the rapid growth of the financial sector, and they were also unable to ensure compliance with the changes in the financial legislation. Notwithstanding these difficulties, the regulators were at fault for not taking an industry approach by providing adequate leadership and planning once the problem had become systemic. The tardiness in intervening once it had become obvious that the sector was in trouble has proved to be a costly mistake in every respect, including the national debt burden, the deterioration of the domestic financial sector, and the economic and social consequences of the "fallout."

Industry Approach

Despite the growing banking crisis in the mid-1990s, the banking sector as a group failed to take an industry position and make joint representation to the government. Instead, each entity acted on its own. In certain instances, public utterances were made by some of the foreign-controlled banks that added to the loss of confidence in the domestic financial sector. The first joint representation came, belatedly, in May 1996 when the insurance industry made representation to the minister of finance. At that time, it was estimated (based on a survey done by

Price Waterhouse) that J$20 billion would be needed to infuse liquidity and solvency into the ailing sector. Specific proposals on the type and amount of funding were made to the minister of finance by individual entities, which had to demonstrate how viability could be achieved. Also, proposals were introduced to regulate the activities of the life insurance companies, and to estimate the level of assistance needed to avert its collapse. There was no intervention or support, however, until 1997.

In the interim, most of the troubled entities sought overseas equity participation and cheaper loan financing, but these initiatives were not successful. The problems escalated and forced them into a position where FINSAC dictated the terms of its support.

The only domestic financial entity that made a formal public offering to raise funds in order to replace high-cost, short-term borrowings was the Eagle Group, but the effort did not succeed. In late 1995, the Eagle Group used the unit trust vehicle to consolidate the investments of its major entities (the commercial bank, the merchant bank, the general insurance company, and the 520-room Holiday Inn SunSpree Hotel), and then offered units to the public through the Eagle Premium Growth Fund. The net asset value of the Eagle entities was J$6.2 billion, but despite its innovativeness and the potentially attractive returns, the offer did not succeed—perhaps because interest rates on Jamaican treasury bills were about 45 percent and because the government also came to the market with a major bond issue. This example demonstrates that in addition to the difficult economic climate in which the financial sector had to operate, it also had to face stiff competition from government in raising funds to help rectify its problems.

Conclusion and Implications

The Jamaican government was late in acting on a structured and pro-active basis to help the troubled domestic financial sector. It did not intervene until early 1997, when FINSAC became operational. By that time the capital base of the domestic financial institutions was wiped out, or nearly so, and the majority of the institutions were facing serious runs. The rescue cost was significantly higher than it would have been in 1996, when the first official proposal for assistance was made to the minister of finance, because interest rates of approximately 30-35 percent were rapidly creating massive losses and wiping out the capital base of most entities. When FINSAC did intervene, its actions suggested differential—even preferential—treatment. It seems that FINSAC had no fixed policy, lost track of its policy when dealing with the entities needing help, or simply acted arbitrarily by providing support to some and taking over the ownership of others. If insolvency was the criteria for takeover, then all the domestic financial entities should have been taken over, because even the "saved" entities would have been insolvent without FINSAC support.

The domestic financial industry was faced with high interest costs, declining value of investments, rising loan and mortgage defaults, and higher operational costs. Their losses accumulated to the point where shareholders' equity was either completely wiped out or was well on the way to being wiped out.

One of the more technical and important policy issues was the key policymakers' strategic objective to separate banking from insurance activities by the so-called Chinese wall. According to this vision, holding companies would not be able to control insurance and banking entities and fewer, hopefully stronger, domestic financial entities would emerge from the reorganization of the sector. This bias against financial conglomerates fails to recognize that greater concentration of financial resources could allow for more efficient decision-making with greater resources, which could be a definite advantage in small economies. Also, the thin line of demarcation between types of financial products accompanied by rapid technological growth makes it difficult to precisely delineate between the products of the banking, insurance, and securities industries.

If financial conglomerates are to operate on a proper basis, the issue of supervision becomes even more important. One possibility is to create of an omnibus supervisory agency to cover the insurance, banking, and securities industries. This would amount to transferring the Bank of Jamaica's regulatory and oversight functions vis-à-vis the banking sector to a newly created agency that would undertake the omnibus role. The Bank of Jamaica would then be free to concentrate on monetary policy rather than operational and day-to-day regulatory functions. Its current regulatory functions are potentially in conflict with the Bank's broader goals, because the Bank is required to make key decisions about specific institutions, including whether they survive or die.

Specific guidelines would be needed to define the types of investments each industry could offer to the public and the types of investments that each could make. For example, life insurance companies could be prohibited from issuing short-term instruments to fund long-term investments. It is important that the regulatory apparatus pertaining to these and other operational issues be upgraded to ensure that the restructuring and behavior of the financial sector is on a sound basis.

If banks are to stick to their core business on the grounds that it was their excursion into the productive sectors that led to their downfall, then it is necessary to identify where the capital is going to be found to undertake domestic investments or to enter into joint ventures. Based on public sentiment, especially that of the business sector, it would seem likely that the government-owned National Development Bank, National Investment Bank of Jamaica, and Agricultural Development Bank will become the prime sources of direct investment and medium-term capital. But with an increasing public sector deficit (now approximately 9 percent of GDP) even before taking into account FINSAC's debts, there will be a funding problem. The issue of the government borrowing more from the domestic capital market, at the expense of the private sector, must therefore be addressed by a planned deficit reduction program.

While development banks have a key role to play, their record with direct lending in Jamaica has been a failure. In the late 1960s, the Development Finance Corporation had to be revamped and was transformed into the Jamaica Development Bank: by the end of the 1970s, it was bankrupt. In the 1980s, a new concept in development banking was introduced with the creation of the National Development Bank and the Agricultural Development Bank, which were to work in partnership with the commercial, and later, merchant banks, with on-lending to clients. The commercial and merchant banks assumed the risk associated with the on-lending. This partnership has proven successful so far, although there are advocates of direct lending by the development banks.

If the model of on-lending through intermediaries were to be discarded or downgraded, then the development banks would assume the credit risks. This would lead to the possibility of a new round of bailouts for those institutions that are now major investors in productive enterprises, especially if current macroeconomic policies do not generate growth and allow for reasonable returns on investments and repayment of loans.

The minister of finance had initially announced that FINSAC would operate for two years. Now that it has become the largest holding company in Jamaica and possibly in the Caribbean, its life has been extended. FINSAC now owns one life insurance company, controls another, and has a 26.5 percent interest in three others; owns four operating commercial banks, at least four building societies, and a unit trust; owns and has stocks in general insurance companies; is the largest owner of hotel rooms in the country; has majority control in the largest nationally-owned commercial bank; and is the largest shareholder in the Caribbean Cement Company.

As interest piles up on the J$75 billion paper that was issued to acquire these companies and the associated investments, the cost of FINSAC will escalate exponentially. It could double in about four years to the size of the 1998/99 national budget. To minimize this growing problem, FINSAC has to set a short timetable to sell its assets at whatever price the market will pay, and this must to be done at a much faster pace than has so far been the case.

The senior partner at Price Waterhouse, Mr. Richard Downer, whose firm has taken an in-depth look at the financial sector, has estimated that the FINSAC debt and other types of bail-out support could be in the region of J$100 billion, representing approximately two-thirds of GDP, more than triple that in Indonesia (20 percent), six times that in Thailand (10 percent), and nearly five times that in Mexico (14.4 percent). Public sector debt is now a matter of grave concern, and could be in excess of 150 percent of GDP when the recent US$250 million government borrowing and FINSAC's debt is taken into account.

In order to resuscitate and define the role of the domestic financial sector, the national debt overhang problem must be addressed. The fact is that investors—whether with short-term capital flows or with portfolio and direct investments—will take into account the future stability of the financial sector which, in turn, is dependent on the strength of the economy. It is therefore critical that FINSAC's debt be integrated into the fiscal accounts and that there be public disclosure of information, using realistic forecasts to demonstrate how the national debt problem will be treated over the next few years. Such forecasts should show projected revenues, pubic sector borrowings, and debt servicing and the impact on interest rates.

The private sector will need such practical information to be able to draw conclusions about where the economy is likely to be going, and what will it mean in terms of investment decisions.

The concept of a "favorable investment climate" is a very complex one, and the formulation of favorable policies, including legal incentives to invest, may not be sufficient to encourage investments. It is imperative that decision-makers have a clearer picture of where the economy is likely to go based on transparent data and information on critical factors. In the case of Jamaica, there are serious concerns about the debt problem, and domestic and foreign investors of all classes will need to know how the government intends to deal with this problem. If it is not addressed, then financing from the Bank of Jamaica, with the resulting impact on inflation and exchange rates, will be inevitable.

FINSAC has brought some stability to the financial sector. However, there has been no meaningful re-structuring of the industry or strategic policy directives on its operations. What FINSAC has accomplished is the take-over of liabilities and assets from the troubled domestic financial sector, the cost of which is now on FINSAC's accounts rather than on the books of the financial entities. By being such a major owner of financial entities and investments, FINSAC now has to move into the formulation of strategic planning for the financial sector.

From a public policy viewpoint, the matter of FINSAC's funding raises a fundamental issue in that Parliament made no budgetary allocation for a company or statutory body to take on financial obligations approximating the size of the national budget. Furthermore, no parliamentary approval has been sought to guarantee the notes issued by FINSAC.

Given the fact that liabilities acquired by FINSAC far exceed the assets acquired, FINSAC is just as insolvent as the entities that it has bailed out. Without a government guarantee, the financial entities to which it has issued paper could have their accounts qualified by their auditors and, under the strict interpretation of the provisions of the various financial laws, could find that they are still technically insolvent. There is, therefore, no choice but to integrate the FINSAC accounts into the national budget and to seek the necessary parliamentary approvals, including formal guarantees for FINSAC paper.

For the future, two key issues are to decide whether to dismantle financial conglomerates and to define the role that life insurance companies and merchant banks should play vis-à-vis direct investments. If an active role is envisaged, then incentives should be introduced to motivate them to once again play a major and dynamic role, especially in the mobilization of long-term funds, both foreign and domestic. Also, guidelines for fund mobilization for both financial entities and the public sector development banks must be introduced.

To conclude with the obvious, it is imperative and urgent that fiscal and monetary policies be put in place that will generate investment and growth. This is necessary regardless of the what policies are developed for the financial sector, because the stagnant economy and high interest rates have had and will continue to have a devastating affect on all sectors of the economy, and will exacerbate the country's serious debt trap.

The current model of over-reliance on monetary policy to restrain demand and to defend the exchange rate has to be revamped, and a more growth-oriented economic model must be substituted. Unless the country moves in this direction, the FINSAC intervention will turn out to be simply an amassment of massive public sector debt, without the offsetting benefit of significant reforms and the restoration of dynamism to the financial sector.

About the Author

Paul Chen-Young has over 30 years experience in the financial sector in Jamaica. He is the founder of the Eagle Merchant Bank and its other entities, which were sold to FINSAC for J$1.00 in March 1997.

Appendix 1
Statistical Profile of Jamaica

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Real Gross Domestic Product (GDP) 2					**(Average Annual Growth Rates)**					
Total GDP	2.9	6.8	5.5	0.7	1.5	1.4	1.1	.05	-1.7	-1.4
Agriculture, Forestry & Fishing	-3.4	-9.1	11.5	-0.2	12.9	10.1	7.4	2.2	3.3	-9.8
Mining & Quarrying	-4.5	35.6	22.8	5.7	-2.5	0.3	6.9	-6.8	7.5	…
Manufacturing	5.4	7.5	3.9	-7.5	1.6	-1.9	0.3	-1.2	-3.1	-4.0
Construction	14.8	18	1.6	0.6	0.4	-0.5	-6.3	7.2	-5.4	5.5
Central Government 3					**(As a Percentage of Current GDP)**					
Current Revenue	28.5	29.9	27.6	28.8	28.7	31.4	32.0	34.5	33.0	32.7
Current Expenditures	26.2	25.8	22.7	22.7	21.4	24.7	26	27.1	34.6	-0.7
Current Savings	2.3	4.1	4.9	6.1	7.3	6.7	6.0	7.4	-1.6	6.1
Capital Expenditures 4	8.8	6.4	4.2	5.1	5.3	4.5	4.0	6.7	7.4	-6.17
Overall Balance (-Deficit)	-1.5	-0.2	3.0	4.4	4.2	3.5	3.6	1.9	-8.1	-6.1
Domestic Financing	-0.6	-2.8	-5.1	-8.2	-3.4	-4.3	…	…	…	…
Money & Credit 5					**(As A Percentage of Current GDP)**					
Domestic Credit	32.5	26.5	24.2	14.9	9.3	11.1	14.6	18.0	17.4	28.3
Public Sector	6.2	-2.3	-2.6	-6.6	-6.4	-6.3	-6.5	-3.1	-3.8	6.0
Private Sector	26.3	28.9	26.7	21.5	15.7	17.4	21.1	21.1	21.2	22.3
Money Supply (MI)	13.6	11.2	11.0	11.1	12.4	13.9	14	12.6	12.3	13.0
Interest Rate 6	14.3	20.2	24.5	27.5	23	39.8	34	26.2	20	15.5
Prices & Salaries					**(Average Annual Growth Rates)**					
Consumer Prices	8.8	17.2	29.8	80.2	40.2	30.1	26.8	25.6	15.8	9.2
Real Wages	…	…	…	…	…	…	…	…	…	…
Exchange Rates					**(Jamaican Dollars per Dollar)**					
Market Rate	5.49	5.74	7.18	12.12	22.96	24.95	33.11	35.14	37.12	35.64
										(Index 1990=100)
Real Effective 7	95.5	89.2	100.0	111.1	127.8	111.8	95.0	94.6	70.9	128.9
										(Index 1980=100)
Terms of Trade	92.3	89.2	86.0	83.0	79.6	78.5	78.4	83.4	89.4	…
Balance of Payments					**(Millions of Dollars)**					
Current Account Balance	47.5	-282.4	312.1	-240.1	28.5	-184.0	16.9	-245.2	-238.4	403.5
Trade Balances 8	-356.9	-589.8	502.1	-391.6	-424.6	-815.1	-513.8	-813.2	-1,263.1	-1,780.9
Exports of Goods (FOB)8	898.4	1,028.9	1,190.6	1,196.7	1,116.5	1,105.4	1,551.0	1,792.7	1,379.4	1,361.2
Imports of Goods (FOB)8	1,255.3	1,618.7	1,692.7	1,588.3	1,541.1	1,920.5	2,064.8	2,605.9	2,642.5	3,142.1
Service Balance	217.7	155.3	329.1	321.8	389.6	437.2	367.2	353.5	…	908.2
Income Balance	-335.2	-350.1	430.0	-438.8	-293.9	-195.9	-294.1	-320.1	…	-219.3
Current Transfers	521.9	502.2	290.9	268.5	357.4	389.8	457.6	534.6	542.3	688.5
Capital & Financial Account Balance 9	-26.7	232.5	348.0	207.6	223.6	227.3	301.2	153.9	509.7	251.4
	1988	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**
Capital Account Balance	-15.4	-15.0	-15.9	-15.7	-17.6	-12.9	14.7	37.1	…	…

Capital Transfers	-15.4	-15.0	-15.9	-15.7	-17.6	-12.9	14.7	37.1	…	…
Financial Account Balance	-11.3	247.5	363.9	223.3	241.2	240.2	286.5	116.8	509.7	251.4
Direct Investment	-12	57.1	137.9	133.2	142.4	77.9	116.8	166.7	…	…
Portfolio Investment	…	…	…	…	…	…	…	…	…	…
Other Investment	0.7	190.4	226.0	90.1	98.8	162.3	169.7	-49.9	509.7	251.4
Change in Reserves (-Inc.)	25.2	39.9	-65.3	52.9	-192.2	-92.9	-331	55.3	-271.3	152.1
Errors & Ommissions	-46.0	10.0	29.3	-20.4	-59.9	49.7	12.9	36.1	0.0	0.0
Total External Debt					**(Millions of Dollars)**					
Disbursed Debt	4,490.2	4,435.9	4,546.2	4,283.0	4,127.4	3,975.8	4,209.4	4,167.3	3,985.0	4,030.7
Debt Service Actually Paid	735.4	642.5	706.3	786.8	710.6	564.0	596.6	673.0	613.0	644.6
					(In Percent)					
Int. Payments Due/Exports of Goods & Non-Factor Serv.	18.3	17.8	15.5	15.2	13.9	12.7	9.5	8.7	…	…

1 Source: IADB Statistics & Quantitative Analysis Unit & Regional Operations Department
2 At market prices
3 Fiscal year ending March 31
4 Includes net lending
5 Mid-year values
6 Weighted nominal deposit rate
7 Trade-weighted calculated using the period average nominal exchange rate
8 Include goods procured in ports by carriers
9 Includes Errors and Ommissions for 1996 and 1997